Office of Chief Counsel
Internal Revenue Service

memorandum

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RTHill

date: August 1, 2002

to: Jerry Li, Large Business & Specialty Program Appeals Team Manager
Attention: Glenn Miyamoto, LBSP San Francisco Appeals Office

from: Area Counsel
(Communications, Technology, and Media: Oakland)

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subject: Interpretation of a closing agreement

[redacted]

U.I.L. No. 7121.01.00
Does a closing agreement prevent recovery of a tentative refund?
Non-docketed Significant Advice Review ("NSAR")

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This advice is in response to your request for assistance, and relies on facts provided by you to our office. If you find that any facts are incorrect, please advise us immediately so that we may modify and correct this advice. This advice is subject to 10-day post-review by the National Office. CCDM 35.3.19.4. Accordingly, we request that you do not act on this advice until we have advised you of the National Office's comments, if any, concerning this advice

ISSUE:

Does a closing agreement which states that it is determining a final tax liability for [redacted] preclude the government from recovering the tentative refund paid to the taxpayer prior to the

execution of the [redacted] closing agreement and arising from a [redacted] NOL carried back to [redacted]?

BACKGROUND FACTS:

You have asked our opinion regarding the effect of a closing agreement regarding the [redacted] tax year on the claimed NOL carried back from [redacted] to [redacted]. The agreement was entered by the Examination Division which was auditing the taxpayer's [redacted], [redacted], and [redacted] tax years. At the conclusion of the examination (or approaching the statute of limitations date) for each year, the government and the taxpayer entered into what eventually was a series of three closing agreements, copies of which are attached hereto as exhibit A.

The first closing agreement, a specific items closing agreement, was signed in [redacted] at the close of the [redacted] tax year (the "first" closing agreement). The specific items effected the loss claimed in [redacted] and would have served to reduce the allowable NOL from [redacted] to [redacted]. The [redacted] tentative refund was not recouped or offset to reflect this agreed decrease in allowable loss carryback (the assessment apparently was awaiting the completion of the [redacted] audit).

The second closing agreement, the disputed effect of which creates the issue herein, was executed at the conclusion of the [redacted] examination in [redacted]. This agreement was a combination agreement styled a "[redacted]." This agreement, among other things, reduced the NOL carryback to [redacted] from [redacted]. The resultant increase in liability due to the reduction of the [redacted] NOL carryback was included in a table which set forth the taxpayers' "internal revenue liability" for each of the tax periods ended in [redacted], [redacted], [redacted], and [redacted]. The table also showed the "Type of Tax," the "Chapter Number, Subchapter Letter of Internal Revenue Code" and "Total of Such Tax Liability For Period." The amount set forth for the "Total of Such Tax Liability" for [redacted] included the reduced NOL from [redacted], but did not include the previously agreed reductions from the [redacted] NOL nor any of the additional adjustments to the [redacted] NOL that were soon to be the result of the [redacted] examination (although everyone expected some substantial additional adjustments would be agreed at the conclusion of the audit). The agent believed that via an attachment to the [redacted] audit report he was making it "clear" that this closing agreement executed at the close of the [redacted] audit (the "second" closing agreement) did not preclude further adjustment to the [redacted] tax liability as a result of the expected modification to the [redacted] NOL. Apparently it was also the understanding of the taxpayer that the parties intended that the

expected adjustment to the [redacted] NOL would modify the final tax liability of the taxpayer for [redacted]. The taxpayer protest states the it need not address this issue of intent regarding preclusion of additional liability for [redacted] resulting from reduced allowable losses for [redacted]. The taxpayer stated that the intent of the parties is irrelevant.

The third agreement was executed in [redacted] at the conclusion of the [redacted] audit. This agreement was a specific item agreement, for which the taxpayer declined to include a paragraph proposed by the agent agreeing to an increase in the [redacted] tax liability as a result of the agreed reduction of the [redacted] NOL. The taxpayer took the position in [redacted] that the second (the "[redacted]") closing agreement precluded any adjustment to the [redacted] liability, even if both parties had intended at the time of signing the agreement that it should not preclude this specific adjustment.

DISCUSSION

The examination division makes several arguments to support its position that it can assess the increase in [redacted] tax which would result from the agreed decrease in the [redacted] NOL if the government is not precluded from the proposed assessment. The examination division's arguments depend on its fundamental propositions that the second closing agreement does not bar the proposed assessment to [redacted] because (a) the term "tax liability" is ambiguous and therefore extrinsic evidence can be introduced to establish the agreement of the parties (which agreement was that further adjustment could be made to the [redacted] liability upon the future agreement regarding the [redacted] allowable NOL); or, alternatively, (b) the agreement is void as there was no "meeting of the minds" at the signing of the closing agreement.

The Internal Revenue ("I.R.C.")Code section that governs closing agreements is § 7121(a), which, in pertinent part, allows the Commissioner to enter into an "agreement in writing with any person relating to the liability of such person ... in respect of any internal revenue tax for any taxable period." Section 7121(b) provides for the finality of such agreements as follows in pertinent part:

> (b)Finality.-If such agreement is approved by the Secretary...such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact--
>
> (1)the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer,employee, or agent of the United States, and

(2) in any suit...such agreement...shall not be annulled, modified, set aside, or disregarded.

Closing agreements are governed by statute and not by contract law, however "contract principles" are used by courts to analyze closing agreements. See, e.g., Marathon Oil C. v. United States, 42 Fed. Cl. 267 (1998). The examination division does not seem to be arguing here that it can make a showing of fraud, malfeasance, or misrepresentation of a material fact under I.R.C. § 7121(b) in order to attack the second closing agreement. Absent such a showing of the statutory grounds for setting aside a closing agreement, the government must fight the strong preference for according the closing agreement finality in arguing general contract principles.

The first argument that the agent makes is that there is an inherent ambiguity in the closing agreement and therefore extrinsic evidence may be adduced to show the intent of the parties in entering the agreement. The claimed ambiguity is in the definition of the term "tax liability." While seductive under the circumstances herein, we strongly urge that the government not make an argument that the term "total tax liability" as used in Forms 866 ("final determination of tax liability" closing agreements) is ambiguous. It seems the government would not want to win such an argument, as that would render all Forms 866 subject to attack. The purpose of entering into closing agreements is to introduce finality, as is clearly set forth in the Code reproduced above and in such regulations as Treas. Reg. § 301.7121-1(a). Moreover, we do not believe that a court would give such an argument great weight, particularly in view of the fact that such Forms 866 were created by the government under the statutory direction to create finality.

At least one court has not been persuaded that the term "tax liability" is ambiguous when a taxpayer argued that the term "tax liability" excluded the claims for refund that the taxpayer and the government had been discussing. In that case, in a factual pattern not dissimilar to the situation presented here, the windfall profit tax liability of petitioner was agreed upon in a closing agreement, and the petitioner argued that the parties intended for plaintiff to be able to pursue refund claims with respect to the windfall profits tax after signing the closing agreement. The court found that the term "liability" was clearly final and not modifiable. Marathon Oil Co. v. United States, 42 Fed. Cl. 267 (1998).

In another fairly recent case, the government made an argument that a statutory term had to be interpreted to be in accordance with the parties' agreement or, alternatively, that a closing

agreement was void because there was no meeting of the minds. In the closing agreement there analyzed, the parties agreed to the allowable "net capital gain," and the government apparently understood this to mean capital gain without the capital gain deduction. There was also some evidence that the taxpayer used the same interpretation as the government, although the taxpayer did not admit at trial that its understanding of the term was such. The court held that the closing agreement was complete as to all essential terms and that both parties agreed to accept the terms by signing the agreement. The court held that there was a meeting of the minds as to the essential terms of the closing agreement even though respondent was mistaken as the effect of one of the terms; therefore the closing agreement was not void. Furthermore, the court would not seriously entertain the "interpretation" argument the government made. The court noted that to allow a party to reopen an agreement under the guise of "interpretation" would jeopardize the finality Congress intended to provide. Estate of Mitchell v. Commissioner, T.C. Memo. 1993-110.

The argument that there was no meeting of the minds in the case before us here, is both factually and legally difficult to support. The closing agreement could likely have reflected the government's understanding of the parties' agreement if a paragraph had been added to explain that the one exception to the finality of the agreement was for future adjustment to the [redacted] NOL carryback. The Ninth Circuit has found that a taxpayer was barred from arguing she was an innocent spouse and therefore she was not liable on the total tax liability she agreed to with her ex-husband in a closing agreement. The Ninth Circuit found it unfortunate that she did not realize that she had to preserve the innocent spouse claim in the closing agreement in order to be able to claim innocent spouse status. However, the taxpayer's failure to understand the legal ramifications could not serve to alter the binding effect of the closing agreement she signed. Hopkins v. United States, 146 F. 3d 729 (9th Cir. 1998).

Even if the mistaken understanding of the effect of determining the taxpayer's total tax liability was only held by respondent, and even if that mistaken understanding was partially created by the taxpayer, we do not think that a court would set aside the agreement absent a showing rising to the level of fraud, malfeasance or misrepresentation of a material fact. It would be difficult to persuade a court that the government's reliance on the taxpayer's behavior (a misleading silence as to the failure to preserve the [redacted] carryback adjustment) was reasonable. In a case described above, which case presents a factual situation not very different from this situation, the court found that even if the government's appeals officer misled the petitioner into believing

it could sign the closing agreement and still pursue its refund claim, the taxpayer's reliance on the appeals officer was not reasonable. The taxpayer should have reached its own conclusion and did not reasonably rely on the government's statement. Marathon Oil Co. v. United States, 42 Fed. Cl. 267 (1998).

The facts herein seem to support the argument that the parties did actually agree that the [redacted] tax liability set forth in the agreement was the final liability for [redacted], including increased tax due to reduced NOL carryback [redacted], but excluding the adjustments to the [redacted] carryback, which carryback the parties already agreed would be adjusted to some extent and for which additional adjustments were also anticipated. This factual scenario seems to present a mistake as to the effect of the term "total tax liability." The mutual mistake of not accounting for the [redacted] NOL is not likely to be sufficient to serve to set aside the closing agreement. Mutual mistake is not a basis for recission. The Tax Court has stated:

> However, section 7121 does not bind the parties as to the premises underlying their agreement; they are bound only as to the matters agreed upon. Sec. 7121(b). In fact by excluding, as grounds for rescission, mistakes of fact or law, the statute contemplates that the parties may premise their agreement upon such a mistake. See Wolverine Petroleum Corp. v. Commissioner, supra.

Zaentz v. Commissioner, 90 T.C. 753, 761 (1988).

CONCLUSION

Although the government has apparently made the types of arguments that would be necessary to make in this case (see, for example, Estate of Mitchell v. Commissioner, T.C. Memo. 1993-110), it is highly unlikely that the government could prevail absent the requisite seminal showing of fraud, malfeasance, or misrepresentation of a material fact. The government has not argued that these prerequisites are present herein. In the absence of such a showing, it is believed that extrinsic evidence could not be introduced to expand the effect of the agreement beyond what was contained in the four corners of the agreement.

We do find the taxpayer's behavior troublesome, especially with respect to the [redacted] specific matters included in the first closing agreement. The effect of that first closing agreement is now vitiated by the second, inconsistent, agreement. To prove that, however, would require extrinsic evidence, and we do not believe we would persuade a court to look at it to invalidate the second

closing agreement.

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Attachments